Letter Ruling 07-2: Security Corporation Classification

July 2, 2007

You have requested a letter ruling on behalf of ********** (SecurityCo). SecurityCo is a wholly owned subsidiary of ********** (Bank), which in turn is a wholly owned subsidiary of ***** (Parent).

I. Facts

The following is a statement of facts provided by you, and upon which we base this letter ruling. SecurityCo is a corporation organized under the laws of the Commonwealth of Massachusetts that has been granted security corporation classification by the Department of Revenue (the Department) pursuant to G.L. c. 63, § 38B(a) for the tax years ending on and after December 31, 1991. Its classification has not been revoked.

SecurityCo invests primarily in U.S. Government securities such as Treasury notes, discount notes and notes and debentures issued by U.S. government agencies. It also engages in securities placement transactions as described in Letter Ruling 93-7 (May 24, 1993).

SecurityCo's Board of Directors believes that SecurityCo could enhance the total return on its portfolio by using its investment securities in transactions known as "repurchase agreements," commonly called "repos." The repurchase agreements are standard transactions governed by a Master Repurchase Agreement form issued by the Bond Market Association. The transactions consist of two parts. First, SecurityCo would sell government securities to a buyer, and the buyer would, in exchange, pay cash to SecurityCo. Later, the buyer would sell the securities back to SecurityCo, and SecurityCo would pay back the original cash value plus an additional amount that is effectively an interest payment. These transactions do not entail physical transfers of securities and cash but, rather, book entries maintained in electronic records.

The payments that SecurityCo receives from a buyer for the sale of the securities will be treated for federal income tax purposes as the principal amount of a loan; the securities it transfers are essentially security for the loan. The payment SecurityCo will make to the buyer in the second part of the transaction will be treated for federal income tax purposes as return of principal (the amount of cash originally transferred by the buyer) and interest (the additional amount).

SecurityCo plans on engaging in these transactions with various buyers, including the Bank and the Parent, as well as unrelated parties, always using the Master Repurchase Agreement form, as well as arms length pricing and timing for the variables that are allowed under the standard agreement.

The transactions under the repurchase agreements are used for temporary cash management, interest rate arbitrage, or borrowing of securities. The repurchase transactions will provide SecurityCo with cash to be used in acquiring newly issued government securities or other portfolio assets. The transactions will provide the buyers an opportunity to earn a return on cash with virtually risk-free collateral.

Repurchase agreements are commonly used by dealers in government securities, financial institutions, and others, and often are arranged through what is known as the "repo market." The repo market is part of the U.S. money market. The term "repo market" refers not to a place but to the collection of participants that have large amounts of cash on one side, and large amounts of securities (most often Treasury securities) on the other, and who wish to use these assets to engage in repurchase agreement transactions. SecurityCo and all other parties to these transactions will engage in the proposed repurchase agreement transactions through this repo market.

II. Rulings requested

1. SecurityCo's engagement in repurchase agreement transactions as described in this ruling constitutes "dealing in securities" for purposes of G.L. c. 63, § 38B.

2. SecurityCo as seller/repurchaser in repurchase agreement transactions, as described in this ruling, may engage in such transactions with either an affiliate or a third party, and continue to qualify as a security corporation under G.L. c. 63, § 38B.

III. Rulings

1. Because the government obligations that are sold and repurchased by SecurityCo in the repurchase agreement transactions described in this ruling are within the meaning of the term "securities" as defined at G.L. c. 63, § 38B(b½), SecurityCo's participation in these transactions qualifies as "dealing in securities" within the meaning of G.L. c. 63, § 38B, provided that the substance of the transactions is not otherwise inconsistent with such qualification (see Ruling #2).

2. Because the substance of the proposed repurchase agreement transactions involves a *borrowing* by SecurityCo from affiliates and third parties (in contrast to transactions that would in substance be characterized as loans to affiliates and others), SecurityCo may engage as a seller/repurchaser in the repurchase agreement transactions as described in this ruling with either affiliates or unrelated third parties and continue to qualify as a security corporation under G.L. c. 63, § 38B.

IV. Discussion

1. Form of Transactions

(a) Dealing in Securities

The first question asks whether engaging in repurchase agreement transactions in the manner described above falls within the meaning of the phrase "dealing in securities" for purposes of G.L. c. 63, § 38B. To answer this question, we must first determine whether the repurchase agreements involve the selling and repurchasing of securities within the meaning of that provision. You have described repurchase agreements as arrangements where an owner first sells government securities to a buyer for a cash purchase price, with the transaction in substance reflecting a secured borrowing by the seller of the amount of the purchase price from the buyer. Eventually, the seller repurchases the securities and pays the buyer an amount that in substance reflects repayment of the principal amount of the loan, plus interest. The purpose of the transaction is for the seller to raise cash to be used in acquiring other investments.

The form of the repurchase agreement transactions entails the selling and buying of what you have represented are securities that meet the terms of G.L. c. 63, § 38B(b½) at the time of their original acquisition. Thus, we assume that prior to the repurchase agreement transactions the government securities qualify as securities in the hands of the owner. Since the transactions involve the selling and purchasing of the same instruments, we must consider whether that action takes them out of the meaning of the statute.

Section 38B(b½), as added to G.L. c. 63 by section 74 of chapter 262 of the Acts of 2004, defines a security as including "equity or debt instruments and options, futures and other derivatives, that are traded on and were acquired through a public exchange or another arms length secondary market." G.L. c. 63, § 38B(b½)(1). You have represented that the government securities in question are debt instruments within the meaning of this provision. Thus, the only remaining requirement the sales and repurchases must satisfy is that they take place through a public exchange or another arms length secondary market.

The term "arm's length secondary market" as defined in the Department's Regulation 830 CMR 63.38B.1(2), Massachusetts Taxation of Security Corporations, contemplates "a venue for purchasing previously issued and outstanding securities that is not related to the seller, the purchaser, or the issuer of the securities being acquired." The materials you have submitted indicate that these repurchase agreement transactions are generally conducted between banks and other sophisticated institutional investors, including mutual funds, large corporations, dealers and securities lenders. These institutional investors "are in touch with and among each other constantly, by telephone, e-mail, Bloomberg, etc." This description can be viewed as generally falling within the ambit of an "arm's length secondary market."

(b) Transactions with Affiliates

You have further indicated that in some cases the institutional investors participating in the repurchase agreement transactions at issue may be related to each other through common ownership. Because the securities are transacted through the repo market, which we have concluded is a broad market venue that is not related to the parties, repurchase agreement transactions with affiliates would not per se disqualify SecurityCo from security corporation status. Moreover, as indicated in the facts presented, the transactions are always undertaken using the Bond Market Association's Master Repurchase Agreement form, as well as arms length pricing and timing for the variables contemplated under the standard form. Based upon these representations, we conclude that for purposes of this ruling the securities can be said to have been traded on or acquired through an arm's length secondary market and, consequently, still fall within the definition of securities as set forth in G.L. c. 63, § 38B(b½).

With respect to transactions with affiliates, the Department's Security Corporations Regulation 830 CMR 63.38B.1(4)(d) provides as follows:

The new definition of "securities" will not be construed to preclude a security corporation from acquiring certain qualifying securities from an affiliate. The Department will not treat a corporation that owns securities that otherwise meet the definition set forth in 830 CMR 63.38B.1(4)(b)(1) as failing to qualify as a security corporation solely because it acquires securities from an affiliate, provided the securities were initially acquired by the affiliate through a public exchange or other arm's length secondary market as part of the affiliate's securities investment activities.

While the transactions contemplated in this ruling relate to the sale/repurchase of securities in an arm's length secondary market as opposed to their initial acquisition by a security corporation, the above-quoted provision connotes that transactions with affiliates do not per se disqualify securities corporations from such status, provided that the substance of the transactions is not inconsistent with security corporation status. Rather, both the form and substance of the transactions must be examined on a case-by-case basis.

2. Substance of Transactions; Borrowing of Funds by SecurityCo

With respect to the form of the transactions at issue, section 6 of the Master Repurchase Agreement submitted with your request provides that "the parties intend that all Transactions hereunder be sales and purchases and not loans." This section further provides that "in the event any such Transactions are deemed to be loans, as security for the performance by Seller. . . . Seller shall be deemed to have pledged to Buyer and to have granted to Buyer a security interest in all of the Purchased Securities with respect to all Transactions hereunder." Although the Agreement establishes the form of the transactions as sales and purchases of securities, they can be readily viewed in substance as securitized borrowings by SecurityCo. This treatment is consistent with the reporting of the transactions for federal tax purposes generally. As previously indicated in the Facts above, the payments that SecurityCo will receive from a buyer for the sale of securities in these transactions will be treated for federal income tax purposes as the principal amount of a loan; the securities it transfers are essentially security for the loan. The payment SecurityCo will make to the buyer in the second, repurchase part of the transaction will be treated for tax purposes as return of principal and interest. The terms of such borrowing would be identical under the Master Repurchase Agreement whether conducted with unrelated parties or affiliates.

The Department's Security Corporations Regulation provides that "securities must be acquired and held exclusively for investment purposes." 830 CMR 63.38B.1(5). While the Regulation, at Example (5)(a.1), goes on to state that "[t]he business of lending money is not the acquisition of

securities for an investment purpose," the converse is not necessarily the case-- i.e., borrowing, undertaken through dealing in securities to facilitate further investment opportunities may constitute dealing in securities for an investment purpose. You have stated that the purpose of the transactions at issue is to "enhance [Security Co's] total return on its portfolio." Based upon this statement and supporting representations, we conclude that, in substance, the transactions at issue constitute borrowing through a dealing in securities undertaken "for an investment purpose" that is consistent with security corporation status. For this reason these repurchase agreement transactions, as a matter of both substance and form, would not disqualify SecurityCo as a security corporation under G.L. c. 63, § 38B.

V. Conclusion

Because the repurchase agreement transactions in which SecurityCo proposes to engage may be considered as selling and buying securities through an arms length secondary market, and do not in substance involve a prohibited activity such as the making of loans to affiliates or the conduct of a lending business, SecurityCo would continue to qualify as a security corporation under G.L. c. 63, § 38B. Repurchase agreement transactions with affiliates can likewise be said to have taken place on or through an arm's length secondary market. Further, the repo market transactions, whether with unrelated parties or affiliates, fall within the parameters of "dealing in securities for an investment purpose." Thus, the proposed transactions would not disqualify SecurityCo as a security corporation under G.L. c. 63, § 38B.

Very truly yours,

/s/Henry Dormitzer

Henry Dormitzer
Commissioner of Revenue

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